Guidelines - the so-called Herfindahl-Hirschman Index (HHI) - is not a proper gauge of whether a regulated firm in a market should be granted or denied pricing flexibility.[119] This is so because the purpose served by the HHI - to assess the possibility that a firm will be able to raise prices by absorbing a rival - has nothing to do with whether pricing flexibility should be permitted by a regulated firm in the face of competitive entry.[120] This is best illustrated by Teleport's own example which states that if a carrier had a 60% market share, and three competitors had market shares of 20%, 10% and 10%, respectively, then the market would be considered "highly concentrated" and, according to Teleport, "not a candidate for relaxed treatment under HHI guidelines."[121] Teleport's example, of course, comes very close to the market structure of the IXC industry. If the Commission had applied the Merger Guidelines as interpreted by Teleport, AT&T would never have been afforded the pricing flexibility that it has today.

USTA continues to believe that "addressability" is a more appropriate measure of LEC market power.[122] Unlike market share measures, addressability is forward-looking and

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[119] See Schmalensee - Taylor Reply, pp. 15-16.

[120] See id.

[121] Teleport Comments, p. 18.

[122] See USTA Comments, pp. 62-63.

considers the real alternatives customers have to LEC access services.[123] Most importantly, such a measure would help to ensure that customers receive the full benefits of competitive pricing and service offerings, and that the decisions of new market entrants will be based on realistic price signals.[124]

E. Other Pricing/Competition Issues.

1. TS-LRIC Should Not Be Used as A Cost Standard.

MFS urges the "Commission to adopt Total Service - Long Run Incremental Cost ('TS-LRIC') as the basic standard for review of LEC rates."[125] MCI makes a similar request with regard to the new service cost standard,[126] as does AT&T concerning the costing of its proposed basic network functions (BNFs) and basic network elements (BNEs).[127] Both

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[123] The addressability standard is not unlike the "availability of competing service" standard employed as one of three alternative tests to determine whether there is "effective competition" in cable markets for purposes of implementing the rate regulation provisions of the Cable Act of 1992. See Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, supra at ¶¶ 26-27.

[124] See USTA Comments, p. 63.

[125] MFS Comments, p. 33. MFS suggests that the TS-LRIC standard should apply to Commission review of below-band filings and to determine the level of "direct" costs attributable to a new service. Id. at 37.

[126] MCI Comments, p. 55.

[127] AT&T, p. 17.

MCI and AT&T would add an allocation of common costs/overheads to the TS-LRIC amounts.[128]

As an initial matter, USTA notes that all of these proposals are designed to limit a LEC's ability to offer services with efficient price structures, including volume discounts, which are used routinely by competing firms in the industry. Further, as discussed above and in USTA's Comments, price caps should focus on the control of prices, rather than on a firm's costs.[129]

Moreover, the TS-LRIC methodology of MFS, AT&T and MCI would inappropriately allocate the volume-insensitive costs of a service (such as a fixed software development cost) to individual service units. The price for any unit of service should exceed the volume-sensitive costs of the service; however, volume-insensitive costs need only be recovered from total service revenues. Thus, the proposed TS-LRIC standard could create an artificially high price floor which, in turn, could deprive consumers of lower (but not

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[128] See id.; MCI Comments, p. 55.

[129] USTA has recognized, however, that it is appropriate to apply an economic cost standard for certain purposes under price cap regulation. For example, under USTA's proposal, a LEC filing that introduces a new service in an IMA would be supported by incremental cost data and a showing sufficient to demonstrate that the prices are reasonable. See USTA Comments, pp. 75-76.

predatory) unit prices.[130] In sum, while it is reasonable to expect that a service as a whole should recover its associated incremental cost, it is not reasonable to use TS-LRIC, or a mark-up above TS-LRIC, as a floor for the price of individual units of service.[131]

Finally, USTA believes that MFS, AT&T and MCI would like LECs to routinely provide TS-LRIC data so that they can review LEC costs for their own competitive and business planning purposes. The Commission should not permit its processes to be used by competitors to obtain data which would be considered highly confidential by virtually any firm.

2. New Services Issues.

The ICA proposes a "price linking" approach to new services.[132] This complex approach would (1) require each LEC to calculate a second, surrogate API (an API-NS that

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[130] For similar reasons, the Commission should reject MFS's suggestion to apply a so-called "cost-consistency" test to all services within the trunking basket. See MFS Comments, p. 18. MFS' proposal would require every rate to bear a constant mark-up over TS-LRIC, which would impose an even higher floor for LEC prices.

[131] Additionally, the proposed TS-LRIC standard implies a theoretical notion of "long-run" which ignores the structure of current telecommunications networks. (The TS-LRIC proposal would, in essence, consider existing investment to be replaced entirely with new, forward-looking technology.) Cost calculations, especially for a complex industry such as telecommunications, should reflect the real world and not economic textbook theories.

[132] ICA Comments, p. 21.

would parallel each basket, reflecting the embedded services in the basket and all new services based on three years' forecasted demand); (2) reduce the LEC's PCI for the basket by the incremental decrease in the API - API-NS differential (when that differential exceeded two percentage points); and (3) require that the surrogate API-NS be updated every quarter to account for changes in actual versus forecasted demand.[133] ICA states that its price linking proposal - which is intended to "discipline" LEC pricing of new services - could eliminate the need for the LEC to seek waivers of particular Part 69 rate structure rules because "[s]ervices tariffed under this approach could be subject to a separate section in Part 69 that would not affect the other rules."[134]

USTA, of course, is all in favor of eliminating the need to seek Part 69 waivers for new services. As USTA has explained at length,[135] the existing process substantially frustrates LEC attempts to introduce new service offerings in a timely fashion, and to repackage existing services in response to customer needs. ICA's proposal, however, takes things in the wrong direction. First, ICA is going against a fundamental feature of price cap regulation which allows

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[133] Id.

[134] Id.

[135] USTA Comments, p. 52-56.

rates to be established independently of other rates, subject, of course, to basket and banding requirements. As the Commission stated in the Price Cap Order, it is "desirable to permit LECs to migrate their rates toward a set of prices that enhances efficiency."[136] Price-linking would not permit this price migration for new services. In short, by tying one set of prices (new services) to another (existing services), price-linking would substantially circumscribe the minimal pricing flexibility currently afforded by price caps, would be economically inefficient, and would send incorrect price signals to both competitors and customers.

Additionally, price-linking is contrary to the Commission's prior conclusion that new services should initially be kept out of price caps because of the lack of reliable demand data.[137] Price-linking would require LECs to estimate demand in order to compute the API-NS. Further, with its system of new price cap indices, linkages, demand tracking and mandatory PCI decreases, ICA's price-linking proposal would add a new level of complexity to the price

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[136] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6791 (1990).

[137] See Second Report and Order, CC Docket 87-313, supra, 5 FCC Rcd at 6825. (We "will keep [new services] outside of price caps for a time, as proposed, in order to enable LECs to develop the historical demand figures we require for computation of our price cap formulas.")

cap plan and would limit the LECs' ability to make competitive rate adjustments. Such complexity would not only require additional resources to be devoted by both LECs and the Commission, it could by itself chill the introduction of new services.

Other parties propose continued or new restrictions on new service offerings under price caps. Teleport, for example, "sees no need for change in the current treatment of new services under price caps."[138] MFS, on the other hand, wants new services to be incorporated into price caps immediately upon becoming effective, and would classify new services based on whether they share underlying network functions and facilities with existing services, regardless of whether the services themselves are similar.[139]

USTA's Comments (pp. 72-77) made clear that the Commission's complicated and ever-changing new service pricing rules, and the tariff filing and approval process for new services, was a major stumbling block to achieving increased and meaningful service innovation by the price cap LECs. Adoption of proposals such as urged by MFS, or even maintaining the *status quo* as argued by Teleport, would

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[138] Teleport Comments, p. 12; see Ad Hoc Comments, p. 29-30.

[139] See MFS Comments, pp. 26-27.

continue, and could aggravate, the intolerable delays now associated with new service introduction.

3. Part 69 Reform Cannot Be Delayed.

Citing USTA's petition for access reform,[140] among other pending matters, MCI states that the "issue of the appropriate rate structure should be considered separately in the context of a Part 69 review, and has no place in the instant proceeding."[141]

MCI is mistaken. The price cap rules and the Part 69 rules are threads of the same regulatory fabric. As USTA discussed in its comments (pp. 102-103), reform of both the price cap rules and the Part 69 rules is essential for achieving such important Commission goals as infrastructure development, economic growth, new service introduction, network efficiency and balanced competition. Moreover, both sets of issues are affected by the same external factors - converging technologies, changing customer demand, and increasing competition - that are rapidly transforming access markets. It simply makes no sense to proceed in one area (*i.e.*, price caps) and not the other (Part 69). The Commission must take the interrelated impacts of both into

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[140] USTA's Petition for Rulemaking, filed September 17, 1993, in RM-8356, Reform of the Interstate Access Charge Rules (USTA Petition).

[141] MCI Comments, pp. 17-18 (footnote omitted).

account in fashioning a regulatory plan that will serve the public interest.

4. There Are No Real Barriers to Entry to Access Markets.

AT&T, MFS and Teleport, among others, are quick to note the so-called "bottlenecks" which they claim prevent full competition with LECs.[142] Virtually all of these alleged "bottlenecks", however, concern the ability of CAPs to compete for basic local exchange service.[143] With few exceptions, these "bottlenecks" are totally unrelated to competition in access markets which is the only relevant kind of competition in this proceeding.[144] Moreover, whatever barriers might have existed in the past, the "incredible rate of entry of CAPs into access and local exchange services provides the strongest possible evidence

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[142] See AT&T Comments, pp. 9-14; MFS Comments, pp. 40-44; Teleport Comments, pp. 18-19.

[143] See AT&T Comments, p. 12 (Expanded interconnection "is merely a necessary but not sufficient precondition for the development of local exchange competition."); MFS Comments, p. 41 ("[I]nterconnection to the LEC network is a critical bottleneck from an operational standpoint, especially for basic local exchange service.") Many of the alleged barriers cited by Teleport (pp. 18-19) are not barriers at all, but are merely tariff issues or reflect the risk and uncertainty present in any business (*i.e.*, Teleport's concern with the "lack of proven economic viability for local exchange services").

[144] See Harris Reply, p. 23. ("Number portability, for example, might be relevant to competition in local services, but it is not a significant factor in access competition.")

that entry barriers have fallen rapidly and dramatically."[145]

One alleged "bottleneck" which could conceivably have an effect on competition in access markets is the ability that CAPs and others have to utilize conduits and rights-of-way.[146] This issue, however, is the proverbial "red herring." In general, any alternative service provider, including IXCs such as MCI, that is certificated by the state to provide some form of telecommunications service has the right to use space in the public right-of-way. Indeed, such providers routinely obtain permits to construct facilities within the public right-of-way. Moreover, CAPs and other service providers can and do negotiate with property owners to obtain necessary easements.

Additionally, in New York City, New York Telephone Company has been obligated under state law for more than a century to make its conduit available on a non-discriminatory basis.[147] Thus, a New York Telephone

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[145] Harris Reply, p. 11 (emphasis deleted).

[146] See AT&T Comments, p. 17; MFS Comments, p. 41; Teleport Comments, p. 18.

[147] See New York Laws 1891, ch. 231, approving a non-exclusive franchise from the City of New York to New York Telephone's subsidiary Empire City Subway Ltd., noted by the Commission in Better T.V. of Dutchess County, 31 FCC2d 939, 944, n. 5 ("Empire City is required to make duct space available to all potential users on a non-discriminatory basis"), recon. denied, 34 FCC2d 142 (1972).

subsidiary offers all parties non-discriminatory access to conduit under the city streets pursuant to a tariff filed with the New York Department of Telecommunications and Energy.

Further, there are numerous alternatives to telephone company conduits that are actively utilized by LEC competitors.[148] These include power company conduit, abandoned water company pipes, and privately-built conduit structures. MCI, for one, acquired the conduits and rights-of-way of Western Union Corp. in the prime downtown locations of a number of major cities.[149] In short, neither the availability of conduits nor rights-of-way pose any real barrier to access competition.

IV. THERE ARE NO VALID REASONS TO INCREASE THE PRODUCTIVITY COMPONENT OF THE PRICE CAP FORMULA, OR TO ADOPT A PER LINE COMMON LINE ADJUSTMENT MECHANISM.

A. Short-Term Earnings Results Are Not a Measure of Long-Term Productivity.

Following the NPRM's cue,[150] several parties call for a higher productivity factor based on claims that LEC earnings

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[148] Indeed, direct burial, as opposed to conduit, is now the preferred construction method for most telephone companies and cable systems.

[149] See *Telecommunications Reports*, "MCI Reportedly Planning Local Networks across U.S.," January 3, 1994, p. 5, 39 ("MCI likely would use rights of way and conduits it acquired from Western Union Corp. in 1990 to build local access networks.")

[150] NPRM, ¶¶ 44-45.

have been excessive under price caps.[151] As discussed below, earnings are not a measure of productivity. In particular, short-term earnings differentials, such as those observed since the start of price caps, are not a measure of long-term total factor productivity (TFP) which is the only appropriate measure of LEC productivity.[152] Further, any attempt to recapture productivity gains based on short-term earnings results would have a substantial adverse impact on LEC incentives under price caps.

At the outset, USTA reiterates that overall LEC earnings levels have been reasonable during price caps[153] and, thus, even if earnings could be considered as a surrogate measure for productivity, there is no reason to increase the LEC productivity factor.[154] Earnings, however, are not a surrogate for productivity. Earnings are based on

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[151] See, e.g., Ad Hoc Comments, p. 18; MCI Comments, p. 22; AT&T Comments, p. 23; OCCO Comments, p. 7; Comments of the General Services Administration (GSA), pp. 8-9.

[152] See USTA Comments, pp. 79-81, Attachment 6. See Harris Reply, p. 26. ("The best indicator of future productivity over the long term is historical experience.") A properly performed TFP analysis demonstrates that the LEC productivity offset should be set at 1.7%. See USTA Comments, p. 81.

[153] See discussion above at Section II; Harris Reply, p. 27. (The "profits earned by LECs are not excessive; they fall well within the range of normal profits, especially considering the steeply increasing business and regulatory risks faced by LECs.")

[154] The evidence actually supports a decrease in the productivity factor. See USTA Comments, pp. 79-84, Attachment 6.

accounting costs, not economic costs which are reflected in the productivity factor. This difference can result in a substantial disparity between earnings and true productivity.[155] For example, where, as in the case of the LECs, depreciation rates are based on asset lives that exceed the actual economic lives of the capital plant employed in producing the firm's output, earnings differentials will overstate the true productivity of the firm.[156]

Further, three years of earnings results, yielding only two years of earnings differentials, can never predict long-term productivity. As Professor Harris notes, "productivity gains fluctuate widely in the short run, whatever the long run rate may be in an industry; hence, one should not draw inference about long term changes in productivity from short run experience."[157] Productivity must be measured over a sufficiently long period of time - 8 to 10 years - so that short-term fluctuations related to expansions and

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[155] See NERA Reply, p. 2. (Analyses of productivity growth implied by LEC earnings are flawed because "historic measures of earnings are based on historic accounting depreciation rates, and a price cap plan intended for use in a future characterized by increasing levels of competition must rely on more realistic economic asset lives.")

[156] See Harris Reply, p. 27. (The "reported profits of LECs are biased upward by regulated depreciation rates that are well below economic levels....") The overstatement of true productivity worsens as the pace of technological change and competitive entry accelerates.

[157] Id.

contractions of the business cycle, and other short-term phenomena,[158] do not have a disproportionate impact on observable results.[159]

Finally, a productivity adjustment based on three years of earnings results would simply recapture any productivity gains achieved by LECs over the price cap period. Such recapture of short-term productivity gains would severely limit the incentives of price cap regulation,[160] and could have deleterious consequences for achieving important Commission goals, such as development of the NII which will require substantial capital investment over a period far exceeding three years.[161]

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[158] These include interest rates, the movement of which do not justify adjustments to the productivity factor as suggested by some parties. See OCCO Comments, p. 8; ARINC Comments, p. 3; but see MCI Comments, p. 18. (The Commission "should not . . . adopt an automatic adjustment to the price cap formula for changes in interest rates.") As noted above, interest expense is not a component of the rate of return calculation.

[159] See USTA Comments, p. 79, n. 202. As noted by NERA, "it is important to distinguish year-to-year fluctuations in the productivity differential (which are to be expected given the documented variability in productivity) from long-term differences due to an error in setting the target." NERA Reply, p. 7.

[160] See Harris Reply, p. 28, ("[T]o increase the productivity offset now would strip away the very incentives that price caps were intended to create.")

[161] See USTA Comments, p. 17. See NERA Reply, p. 8. (Resetting the productivity factor after three years "would replace the incentives of price cap regulation with those of rate of return regulation with a three year lag.")

B. There Are Serious Deficiencies in the Productivity Studies Submitted by Several Parties.

1. Ad Hoc:

Ad Hoc has submitted a study which purports to show that the price cap productivity factor should be increased from 3.3% to "at least 5.8%."[162] Although Ad Hoc correctly views a TFP study as the appropriate way to determine LEC productivity,[163] Ad Hoc errs in its calculation of that productivity. Moreover, Ad Hoc mistakenly increases its productivity growth factor by 1 percent - the alleged difference between LEC input price growth and GNP-PI growth. It also tacks on an unsupported 1 percent "consumer productivity dividend."[164] Both of these additions serve to further invalidate Ad Hoc's recommendation for a new productivity factor.

Ad Hoc bases its TFP growth rate - 3.8% - on an average of the growth rates determined in seven states.[165] An initial problem with Ad Hoc's approach is that it is limited

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[162] Ad Hoc Comments, p. 21, n. 21; Attachment A, p. 58, n. 105.

[163] Id. at 18, Attachment A at 52. The ICA also supports the use of a TFP analysis. ICA Comments, p. 13.

[164] See Ad Hoc Comments, pp. 18-22, Attachment A, pp. 47-64.

[165] See Ad Hoc Comments, Attachment A, pp. 54, 58, 59, Table 6. It is noteworthy that for three of those seven states Ad Hoc relies on studies by Dr. Lauritis R. Christiansen, USTA's principal economic expert on determining a LEC TFP factor in this proceeding.

to only those seven states and, unlike USTA's analysis, does not reflect productivity experience in all states.[166] Moreover, "productivity offsets in state plans are not directly comparable - with each other or with the FCC interstate access price cap productivity offset . . . ."[167] Additionally, the growth rate shown for Delaware - 5.4% - is inconsistent with the testimony last year of Lee L. Selwyn before the Delaware Public Service Commission. At that time, Selwyn, who is also Ad Hoc's principal economic consultant in this proceeding, testified that the applicable "productivity benchmark" was 3.5%.[168]

Ad Hoc's addition of 1% to the productivity factor to account for an input price differential is predicated on its allegation that "LEC input prices rise an average of one percentage point more slowly than GNP-PI."[169] Contrary to

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[166] See NERA Reply, p. 6. Ad Hoc's sample is further skewed because its sample is geographically concentrated - six of the seven states are contiguous to each other in the Northeast and Midwest sections of the country. See Ad Hoc Comments, Table 6.

[167] NERA Reply, p. 10.

[168] See Direct Testimony of Lee L. Selwyn, PSC Regulation Docket No. 33, Delaware Public Service Commission, May 17, 1993, p. 45. If Ad Hoc's calculations are corrected solely for this inconsistency, its claimed average growth rate drops from 3.8% to 3.5%. See NERA Reply, p. 20, n. 40.

[169] Ad Hoc Comments, p. 19. Ad Hoc claims that this is relevant because, it alleges, the Commission's price cap formula was premised on the assumption that LEC input prices rise faster than GNP-PI. Id.

this claim, however, NERA has shown that there is no statistically significant difference between long-term LEC industry and U.S. input price growth.[170] Further, Ad Hoc's study is simply faulty. It relies on the same seven states, noted above, which "are inadequate to measure national LEC productivity and input price growth . . . ."[171]

Ad Hoc also "systematically ignores studies that contradict its assertion" regarding the input price differential.[172] Additionally, in making its recommendation here, Ad Hoc purports to rely on a proposed decision by a California administrative law judge (ALJ).[173] In fact, the ALJ's proposed decision did not include an input price adjustment. Moreover, the final decision of the California Public Utilities Commission completely rejects the input price differential in the productivity component of

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[170] See USTA Comments, Attachment 5, pp. 14-16; NERA Reply, pp. 23-26, Tables 1 and 2.

[171] NERA Reply, p. 23.

[172] Id. For example, Ad Hoc ignores a study performed by NERA for Pacific Bell in California which "showed that LEC input prices grew slightly faster - but not statistically significantly faster - than U. S. input prices over the 1984 to 1992 time period." Id.

[173] See Ad Hoc Comments, Attachment A, p. 50. The alleged California differential, which was proposed by Selwyn and David Roddy, the same economists employed here by Ad Hoc, plays a large role in the calculation of the 1% addition to the productivity growth factor proposed by Ad Hoc in this proceeding. See id., Attachment A, p. 59, Table 6.

California's incentive regulation plan.[174] Other states appear also to be rejecting arguments for the inclusion of an input price differential.[175] The Commission should do the same.

The Commission should also reject Ad Hoc's proposal to increase the consumer productivity dividend to 1%. The only reason Ad Hoc provides for its proposal is that a "stretch component should be applied as a further offset to the GNP-PI inflation index."[176] Ad Hoc fails to explain why the dividend should be increased from its current 0.5% level. Such an increase would, in essence, amount to a double compounding of the stretch factor that is built into the current levels of the PCIs.[177] Actually, the consumer

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[174] See Applications of GTE California and Pacific Bell for Review of the Operations of the Incentive-based Regulatory Framework Adopted in Decision 89-10-031, Applications Nos. 92-05-002 and 92-05-004, Decision, June 8, 1994, pp. 12-14.

[175] Pennsylvania is another of the seven states included in Ad Hoc's analysis. Ad Hoc shows a growth rate of 2.9%, and an input price differential of 0.3%, for a combined "Base X Factor" of 3.2% for Pennsylvania. See Ad Hoc Comments, Attachment A, p. 59, Table 6. Recently, the Pennsylvania Public Utilities Commission announced that the total productivity offset would be 2.93%, apparently rejecting the input price differential recommended by Ad Hoc. See Pennsylvania Public Utility Commission, Press Release, June 2, 1994.

[176] Ad Hoc Comments, p. 22.

[177] See NERA Reply, p. 31. As NERA correctly observes, the "mere fact that the price cap plan is being reviewed does not warrant further arbitrary increases in the productivity offset above its historical level." Id. at 32.

productivity dividend should be eliminated.[178] As Professor Harris noted, there is "no economic rationale for incorporating a 'stretch' factor in the price cap mechanism . . . ."[179]

2. MCI:

According to MCI, the Commission erroneously included the 1984 tariff year data point in one of the two studies it used to determine its productivity factor.[180] MCI claims that without that data point, "the short-term productivity study measuring LEC productivity under rate of return regulation from 1984 to 1989 would support a productivity factor of 5.9%."[181] MCI proposes that the Commission "rely solely on the short-term post-divestiture productivity study" without the data point,[182] and ignore the longer-term study that the Commission also used to determine the initial productivity factor.

It is difficult to comprehend the logic behind MCI's proposal. Based solely on its unsupported claim that LECs

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[178] See USTA Comments, p. 84.

[179] Id., Attachment 2, p. 25. See Harris Reply, p. 27. Harris observes that "consumers have already received a 'dividend' through lower depreciation rates that are implicit in the initial rates covered by the price cap plan." Id.

[180] MCI Comments, p. 21.

[181] Id. at 22.

[182] Id.

"have realized high profits" under price caps,[183] MCI would have the Commission (1) reverse itself on an issue that was thoroughly debated before;[184] (2) discard a longer-term study also utilized by the Commission; and (3) rely on a study that is based on only five years' data through 1989.[185] In short, MCI provides no new evidence on productivity.

Additionally, MCI's reasoning for rejecting the 1984 data point is fundamentally wrong. Contrary to the gist of MCI's argument,[186] the 1984 data point was not a statistical aberration or "outlier."[187] Moreover, even if that data point was unusual as compared to succeeding years, that does not mean that the data point was inaccurate, or that the value of that data point in measuring LEC productivity is in any way diminished.[188]

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[183] Id. Of course, as explained above, not only have LEC earnings been reasonable under price caps, there is no relation between short-term earnings and long-term productivity.

[184] See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Supplemental Notice of Proposed Rulemaking, 5 FCC Rcd 2176, 2219 (1990); Second Report and Order, 5 FCC Rcd 6786, Appendix C, ¶ 28 (1990).

[185] The study is also inappropriate for determining LEC productivity, particularly where, as here, price caps have been in effect for some time. See USTA Comments, p. 80, n. 204.

[186] MCI Comments, p. 21.

[187] See NERA Reply, pp. 11-12.

[188] See id. at 12-13.

In sum, MCI's productivity argument should be rejected out-of-hand. Likewise, the Commission should reject MCI's corresponding claim that, because MCI's "new productivity factor" is 2.6% above the 3.3% factor utilized by the Commission for the past 3 years, LECs must reduce their price cap indices by 7.5%. Not only is this claim based on MCI's discredited data point argument, but such an adjustment would be a particularly deleterious form of productivity recapture that would substantially dampen the future investment and efficiency incentives of price cap regulation. It would also constitute unlawful retroactive ratemaking because its purpose is to recapture what MCI alleges to be excessive past charges.[189]

3. AT&T:

AT&T argues that based on its review of Tariff Review Plan (TRP) and ARMIS data, "the price cap LECs achieved an overall annual productivity of approximately 5.97 percent from January 1991 to December 1993 . . . ."[190] AT&T recommends that the LECs' productivity factor be revised upward to this level, less a LEC "productivity dividend" of

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[189] See Accounting for Judgements and Other Costs Associated with Litigation, 8 FCC Rcd 6655, 6658 (1993). (The retroactive ratemaking "doctrine generally forbids ratemaking that attempts to correct for charges that were either too high or too low in the past.")

[190] AT&T Comments, p. 23, Appendix B.

0.5 percent for exceeding the Commission's 3.3 percent goal.[191]

AT&T did not provide sufficient data to validate its calculations. Nevertheless, as noted above, the short-term earnings results underlying AT&T's proposal are not a proxy for long-term productivity.[192] Productivity exhibits fairly large year-to-year variations, so that any deviation from a predetermined value - here 3.3% - is well within expectations and is not indicative of a fundamental problem with the productivity factor.[193] Moreover, AT&T's calculations, to the extent that they can be discerned, appear to have been based on what AT&T assumed to be a single year's productivity gain. This substantially overstates AT&T's claimed productivity calculation.[194]

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[191] AT&T Comments, pp. 23-24.

[192] See NERA Reply, p. 34.

[193] See NERA Reply, p. 7. For this same reason, GSA's recalculation of the productivity factor based on cumulative earnings results over the three-year price cap period (GSA Comments, pp. 8-10), does not support an upward adjustment of the productivity factor.

[194] See NERA Reply, p. 35. Among other flaws in its methodology, AT&T included only seven of the twelve price cap LECs in its analysis, ostensibly because "it would have been extremely laborious" to include the other carriers. (AT&T Comments, Appendix B, p. B-3.) GTE, the largest of the price cap LECs, was among the carriers omitted. GTE's data would have significantly lowered AT&T's productivity calculation.

In sum, none of the studies offered to support a higher productivity factor, or reduced price cap indices, stand close scrutiny. They are all predicated on the invalid notion that long-term productivity can be ascertained from short-term earnings results. They would all "recapture" any short-term productivity gains and, thus, dampen the important incentives that are at the heart of price cap regulation. Finally, the studies have serious flaws in their assumptions and/or mechanics. For all of these reasons, these studies do not support an increase in the price cap plan's productivity factor.[195]

C. There Is No Reason to Adopt a Per Line Carrier Common Line Adjustment Formula.

The formula for adjusting common line demand is closely related to the productivity issue. As USTA explained in its comments (pp. 84-85), a common line adjustment formula is not necessary when using an appropriate, comprehensive TFP analysis for determining the productivity offset. This is so because any common line adjustment formula would "double count" the growth in LEC output that is already reflected in the TFP study.

Although USTA has shown that the common line adjustment formula should be eliminated, a few parties try to provide

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[195] Nor is there any basis for increasing productivity as an offset for other changes to the price cap plan, such as eliminating sharing. See Sprint Comments, p. 12.

rationales as to why the Commission should switch from a 50/50 formula to a per line formula which would attribute all common line growth to the IXCs. AT&T argues that the substitution of a per line formula for the 50/50 formula is justified because the balanced formula has allegedly not produced a stimulation in demand growth.[196] MCI contends that the 50/50 formula is inappropriate because LECs supposedly do not make any material contribution to common line demand growth.[197]

As an initial matter, the fact that demand growth may have slowed under price caps cannot be attributed necessarily to the LECs, or to the operation of the common line formula. Other factors are likely responsible for the demand growth decrease. These include a downturn in the economy, increasing long-distance rates, and the growth of competitive alternatives to LEC access services. Indeed, the rate of growth might have been even lower were it not for the LECs' initiatives.

Further, there is no basis for denying a positive LEC impact on demand stimulation. In addition to LEC advertising, LECs provide services such as call waiting and

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[196] AT&T Comments, pp. 26-28. AT&T notes that even the per line formula is a second-best solution, and that the Commission should, instead, allow all common line costs to be recovered through end-user charges. Id. at 27, n. 34.

[197] MCI Comments, pp. 35-38; see also Sprint Comments, p. 17.

voice mail which facilitate call completion, including completion of interstate calls.[198] Certainly, the provision of equal access, along with ever lower access rates,[199] has played a major role in increasing interstate calling, particularly by MCI and other competitors of AT&T. Finally, new technologies being installed by LECs, such as SS7, will help stimulate IXC usage.[200]

V. EXOGENOUS COSTS AND SERVICE QUALITY REPORTING.

A. The Commission Should Reject Arguments Concerning the Scope of Exogenous Cost Treatment.

AT&T calls for exogenous cost treatment of fully amortized equal access network reconfiguration costs (EANR).[201] Although the Commission rejected such treatment in its order on reconsideration of the LEC price cap plan,[202] AT&T argues that because the amortization of EANR costs was completed last year, and because these costs have been fully recovered by the LECs, it is appropriate to treat the expiration of the amortization as an exogenous cost change just as the Commission treats as exogenous the

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[198] See Harris Reply, p. 28.

[199] See id.

[200] See Harris Reply, p. 28.

[201] AT&T Comments, p. 46.

[202] See Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, CC Docket No. 87-313, FCC 91-115, released April 17, 1991, ¶ 67, n. 77.